SBA Loans

Guidelines for using SBA 7(a) loan for Acquisition Financing

Eligibility and qualification for financing of a business acquisition is subject both to SBA rules (since most credit unions/banks prefer lending for business acquisition with an SBA guarantee), and to the credit standards of the credit union themselves. The screening criteria below include both SBA rules and typical banking standards. It is always best to consult an SBA lending professional at Gesa Credit Union on questions of eligibility and qualification.

1. Loan Size

Typical borrower down payment is 10%, seller financing is an additional 10% to 15% and the Bank loan is typically 75% to 80% of total costs (selling price, plus working capital, plus loan fees and costs).

In practical terms, SBA financing can play a significant role in deals with selling price up to $5 million depending on down payment available from buyer, seller's willingness to finance a larger-than-normal percentage of the transaction; and availability of other types of financing (such as equipment leasing and current-asset financing).

- **Maximum Transaction Size:** given the above considerations, SBA financing is rarely practical for transactions with a sale price exceeding $6 million; most SBA-financed transactions are at $4 million and below.
- **Minimum Transaction Size:** SBA specifies no minimum loan size. Most lenders active in acquisition finance find loan sizes under $100,000 to be uneconomic.
- **Maximum and Minimum EBIDAT:** following the above, at typical multiples companies with EBIDAT under $150K or over $2 million are likely to be too small or too large respectively.

(Note: EBIDAT is Earnings Before Interest, Depreciation, Amortization and Taxes (if C Corp)

Total SBA Exposure: SBA's "total exposure" to any one borrower plus all affiliates is currently 75% of the maximum loan amount, hence $1.5 million. The guaranteed portion of any outstanding SBA debt of the borrower and all affiliates must be subtracted from the total exposure limit, to determine how much additional SBA guarantee can be available to support lending to the company. (Since existing debt is usually paid off out of seller's proceeds in an acquisition, this provision rarely comes into play in acquisition finance).

2. Trends in Gross Revenues and EBIDAT

Downward trends in EBIDAT, continuing downward through the current year interim statements, are not acceptable for financing. This is true regardless of the level of adjusted net earnings (Sellers Discretionary Earnings or EBIDAT), or the multiple of net earnings in relation to debt service: it is the trend which is disqualifying. Downward gross revenue trends are usually disqualifying, unless EBIDAT is stable or increasing at the same time (usually indicating shift to lower volume but higher-margin business).

A dip in gross or net revenues for a year or two can sometimes be tolerated (COVID 19 pandemic) when the trend has flattened or has been reversed for a full calendar or fiscal year (usually at least 9 months' flat or improving trend must be shown, and for such a partial-year recovery, approval will be contingent on reviewing yearend statements prior to closing). Credit Unions typically underwrite based on the calendar or fiscal year period for which tax returns are filed, not based on 12-month trailing periods, or projections.

3. Business Size Standards

Borrowing business, taken together with all affiliates (any entities holding a 20% or greater interest in the applicant, and any entities in which the applicant or its principals have a controlling interest) cannot exceed either:

(1) The maximum tangible net worth may not exceed $15 million; and (2) The average net income after Federal income taxes (excluding any carry-over losses) for the 2 full fiscal years before the application date may not exceed $5.0 million.

As a rule of thumb, companies listed on stock exchanges (NYSE, NASDAQ) are probably too large to be eligible.

NOTE: in a business asset purchase, the applicant or borrowing company is the entity purchasing the assets; in a business stock purchase by individuals, the applicant or borrowing company is the company whose stock is being acquired.

4. Change of Ownership Considerations

Exiting owners must exit completely. A selling owner cannot retain any ownership after the transaction, and may not be an officer, director, employee, or consultant of the business for longer than 12 months after the sale.

SBA will not finance a partial change of ownership. If one or more partners are buying out another partner or partners, the transaction must result in 100% ownership by the purchasing owners. An existing owner cannot be financed to purchase the partial ownership interest of another partner (for example, with 3 partners, one partner may not buy out a single other partner.) An outside party (someone not currently an owner) cannot purchase anything less than 100% ownership (for example, if there are partners, must buy out all the partners).

Business real estate involved in a business purchase cannot be financed separately from the SBA-guaranteed loan unless the SBA lender is given a shared (pari passu) lien position with the real estate lender.

Exception: OK to use an SBA 504 loan for real estate, together with an SBA guaranteed (7A) loan for the business acquisition.

A leasehold business, as of closing date, must have a lease term plus extensions equal to the term of the SBA loan (usually, 10 years) --or else be able to demonstrate that location is not a critical factor, and that equivalent space at equivalent rent is readily available in the local market.

Landlords must be willing to sign a "landlord's consent," allowing lender to enter the premises to seize collateral in event of a default.

5. Requirements for principals (20% or greater shareholders; officers, directors)

- All principals must personally guarantee the SBA-guaranteed loan—no exceptions.
- If the SBA loan is not 100% secured by hard assets of the business (real estate and FFE only) at liquidation value of the assets, then principals may require a pledge of personal assets (typically real estate and significant financial assets), up to the point that the loan is 100% secured (This is only for loans $350,000 and above). If all available resources are pledged and loan is still not fully secured, collateral shortfall is not a reason for decline.
    - Life Insurance may be needed through if it's a single owner and there is a collateral shortfall.
- Principals must be active owner-managers, not passive investors.
- Principals must have related-industry ownership/general management experience, with strong preference for same-industry experience in independent business
- Principals must have good credit history (generally, at least a 650 FICO score) with no bankruptcies in last 7 years. Judgments, defaults, and frequent delinquencies may disqualify.

- Principals must be of good character: all arrests for other than minor traffic violations must be disclosed; more than 3 misdemeanors or any felony may be disqualifying.
- Principals (at minimum, those who will be active managers) must be US citizens or resident aliens with a green card.

6. Equity Injection (down payment).

SBA does require at least 10% down (5% must be from guarantor cash at minimum)

- **Buyer Equity** - Banks typically require at least 10% of total project costs to be injected by the borrower. (Total project costs = purchase price, plus loan fees, plus required working capital). Usually, up to half that requirement (5% of total costs) can come in the form of seller take-back financing that is on full standby, receiving no payments of principal or interest for the term of the SBA note, or until that note is paid off.
- **Seller Financing** - Banks will generally also require some amount to be financed by the seller (including, not in addition to, any "standby note" such as the above.) Exception: when the borrower is a current key employee or manager of the business being acquired, seller financing may not be required.
- **Intangibles** - If the purchase price of the business includes $500,000 or more of intangibles (goodwill, patents, non-competes, trade name, customer list, etc. SBA requires that there must be combined buyer and seller equity equal to at least 25% of the purchase price. "Seller equity" is defined, for this purpose, as any seller take-back financing for which payments are deferred for at least 2 years. When real estate is transferred along with the business this 25% equity rule applies to the real estate also (unless the RE is split off into a separate 504 loan).

7. Ineligible Businesses

- Ineligible businesses include those engaged in illegal activities, loan packaging, speculation, multi-sales distribution, gambling, investment, or lending, or where the owner is on parole. Specific types of businesses not eligible include:
- Real estate investment firms, when the real property will be held for investment purposes as opposed to loans to otherwise eligible small business concerns for the purpose of occupying the real estate being acquired.
- Firms involved in speculative activities that develop profits from fluctuations in price rather than through the normal course of trade, such as wildcatting for oil and dealing in commodities futures, when not part of the regular activities of the business.
- Dealers of rare coins and stamps are not eligible.
- Firms involved in lending activities, such as banks, finance companies, factors, leasing companies, insurance companies (not agents), and any other firm whose stock in trade is money.
- Pyramid sales plans, where a participant's primary incentive is based on the sales made by an ever-increasing number of participants. Such products as cosmetics, household goods, and other soft goods lend themselves to this type of business.
- Firms involved in illegal activities that are against the law in the jurisdiction where the business is located. Included in these activities are the production, servicing, or distribution of otherwise legal products that are to be used in connection with an illegal activity, such as selling drug paraphernalia or operating a motel that permits illegal prostitution.
- Gambling activities, including any business whose principal activity is gambling. While this precludes loans to racetracks, casinos, and similar enterprises, the rule does not restrict loans to otherwise eligible businesses, which obtain less than one-third of their annual gross income from either the sale of official

state lottery tickets under a state license, or legal gambling activities licensed and supervised by a state authority.
- Charitable, religious, or other non-profit or eleemosynary institutions, government-owned corporations, consumer and marketing cooperatives, and churches and organizations promoting religious objectives are not eligible. s. Business with Franchise/Licensee/Dealer/Jobber agreement that does not meet SBA standards (imposes “unacceptable control,” thereby renders the business effectively an affiliate or subsidiary of the franchisor or licensor).

8. Ineligible Uses of Funds

- Payments, distributions, or loans to principals: NO CASH OUT to PRINCIPALS
- Business relocations that cause unemployment; financial hardship to leaseholder; or nullify labor agreement
- Investments in real or personal property acquired and primarily held for sale, lease or investment (including remodeling of rental space)
- Illegal Activities
- Refinancing debt owed to an SBIC
- Payment of delinquent payroll taxes (income taxes eligible, but a credit issue)
- Use of funds for refinancing is allowed, but subject to numerous restrictions— consult with a Gesa Credit Union SBA lending professional on any proposed refinance.

9. Ineligible Personal Guarantors / Principals (20% or more owner/shareholder)

- Principal is on probation, parole or pending criminal charges, or has a legal history demonstrating poor character or “moral turpitude.”
- Principal has caused a prior loss to the government: -defaulted student loans -delinquency on trust fund taxes (Social Security, Medicare, UI, Work Comp) -loss, whether through settlement or otherwise, to any federal agency
- Conflict of interest: principal is a high government or military official, or an employee of SBA.

Other SBA Items may be needed or can change at any time. Make sure to talk to your Gesa Credit Union SBA Relationship Manager for more information

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